FILED
JUL 27 2007
OFFICE OF THE CLERK

(5)

No. 06-989

In the
Supreme Court of the United States

HALL STREET ASSOCIATES, L.L.C.,

Petitioner,

v.

MATTEL, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF PETITIONER

DEBORAH J. LA FETRA
TIMOTHY SANDEFUR
Counsel of Record
Pacific Legal Foundation
3900 Lennane Drive, Suite 200
Sacramento, California 95834
Telephone: (916) 419-7111
Facsimile: (916) 419-7747

Counsel for Amicus Curiae Pacific Legal Foundation

QUESTION PRESENTED

Did the Ninth Circuit Court of Appeals err when it held, in conflict with several other federal courts of appeals, that the Federal Arbitration Act (FAA) precludes a federal court from enforcing the parties' clearly expressed agreement providing for more expansive judicial review of an arbitration award than the narrow standard of review otherwise provided for in the FAA?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF AUTHORITIES iii

IDENTITY AND INTEREST OF AMICUS CURIAE 1

SUMMARY OF ARGUMENT 1

ARGUMENT 3

I. PARTIES SHOULD BE FREE TO ALTER THE DEFAULT RULES GOVERNING CONTRACTS 3

A. Freedom Means Choice 3

B. Allowing Parties To Tailor Their Agreements Encourages Efficiency and Prosperity 7

II. THE FEDERAL ARBITRATION ACT WAS DESIGNED TO MAXIMIZE FREEDOM OF CHOICE 10

III. PARTIES WHO EXPAND JUDICIAL REVIEW OF THEIR ARBITRATION AGREEMENTS UNDER THE FAA ARE NOT "CREATING JURISDICTION BY CONTRACT" 16

CONCLUSION 22

TABLE OF AUTHORITIES

Page

Cases

Advance-Rumely Thresher Co. v. Jackson,
287 U.S. 283 (1932) 7

Chicago Typographical Union No. 16 v. Chicago Sun-Times, Inc.,
935 F.2d 1501 (7th Cir. 1991) 2, 17-18

Cingular Wireless, LLC v. Mendoza,
126 S. Ct. 2353 (2006) 1

Dean Witter Reynolds, Inc. v. Byrd,
470 U.S. 213 (1985) 2, 10, 20-21

Elmora Hebrew Ctr. v. Fishman, Inc.,
570 A.2d 1297 (N.J. Super. Ct. 1990) 13

Ethyl Corp. v. United Steelworkers of America,
768 F.2d 180 (7th Cir. 1985) 2, 18, 20

Gentry v. Superior Court, No. S141502 (Cal. Sup. Ct. *petition for review filed* Feb. 28, 2006) 1

Grafton Partners L.P. v. Superior Court,
36 Cal. 4th 944 (2005) 1

Heydon's Case, (1584) 76 Eng. Rep. 637 (K.B.) 15

Hill v. Norfolk & Western Ry. Co.,
814 F.2d 1192 (7th Cir. 1987) 18-19

Indep. Employees' Union v. Hillshire Farm Co., Inc., 826 F.2d 530 (7th Cir. 1987) 18-19

Kyocera Corp. v. Prudential-Bache Trade Services, Inc., 341 F.3d 987 (9th Cir. 2003) 20

LaPine Tech. Corp. v. Kyocera Corp.,
130 F.3d 884 (9th Cir. 1997) 18

TABLE OF AUTHORITIES—Continued

Page

Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983) 17

Pierson v. Ray, 386 U.S. 547 (1967) 15

Smith v. Townsend, 148 U.S. 490 (1893) 15

Southland Corp. v. Keating, 465 U.S. 1 (1984) 12

United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29 (1987) 18-19

United Steelworkers of America v. American Mfg. Co., 363 U.S. 564 (1960) 19

Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ., 489 U.S. 468 (1989) 2-3, 7, 13

United States Statutes

9 U.S.C. § 10 ..... 2, 14-17

§ 9 ..... 2, 13-14

28 U.S.C. § 1331 ..... 2, 17

§ 1332 ..... 2, 17

29 U.S.C. § 173(d) 18

§ 185 (1982) 19

U.C.C. § 1-205 (2007) 8

§ 2-305 (1998) 5

Rules of Court

Fed. R. Civ. P. 39(a) 17

Sup. Ct. R. 37.3(a) 1

TABLE OF AUTHORITIES—Continued

Page

Miscellaneous

Advantages Ascribed to Arbitration, 9 J. Am. Jud. Soc. 73 (1925) 16

Ayres, Ian & Gertner, Robert, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989) 6

Barnett, Randy E., *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821 (1992) 5, 7-8

Benson, Bruce L., *The Enterprise of Law* (1990) 9

Blum, Brian A., *Contracts* (2d ed. 2001) 4

Boudreaux, Donald J., et al., *Talk is Cheap: The Existence Value Fallacy*, 29 Envtl. L. 765 (1999) 21

Buchanan, James M., *Rights, Efficiency, and Exchange: The Irrelevance of Transactions Cost* (1984), *reprinted in* James M. Buchanan, 1 *The Logical Foundations of Constitutional Liberty* (1999) 11, 21

Cole, Sarah Rudolph, *Managerial Litigants? The Overlooked Problem of Party Autonomy in Dispute Resolution*, 51 Hastings L.J. 1199 (2000) 9, 14

de Soto, Hernando, *The Mystery of Capital* (2000) 4

Dibadj, Reza, *Weasel Numbers*, 27 Cardozo L. Rev. 1325 (2006) 11

TABLE OF AUTHORITIES—Continued

Page

Drahozal, Christopher R., *Contracting Around RUAA: Default Rules, Mandatory Rules, and Judicial Review of Arbitral Awards*, 3 Pepp. Disp. Resol. L.J. 419 (2003) 5

Drahozal, Christopher R., *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, 78 Notre Dame L. Rev. 101 (2002) .. 12

Epstein, Richard A., *Unconscionability: A Critical Reappraisal*, 18 J.L. & Econ. 293 (1975) 3

H.R. Rep. No. 96, 68th Cong., 1st Sess. (1924) 12

Haddock, David D., et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701 (1987) 9

Hang, Lan Q., *Online Dispute Resolution Systems: The Future of Cyberspace Law*, 41 Santa Clara L. Rev. 837 (2001) 9-10

Hayek, Friedrich A., *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519 (1945) 4

Heuston, Alfred N., *The Settlement of Disputes by Arbitration*, 1 Wash. L. Rev. 243 (1926) 12

Kirzner, Israel M., *Market Theory and the Price System* (1963) 11

Koptsiovsky, Milana, Note: *A Right to Contract for Judicial Review of an Arbitration Award: Does Freedom of Contract Apply to Arbitration Agreements?*, 36 Conn. L. Rev. 609 (2004) 13

TABLE OF AUTHORITIES—Continued

Page

Kronman, Anthony T., *Specific Performance*, 45 U. Chi. L. Rev. 351 (1978) 9

Poor, Wharton, *Arbitration Under the Federal Statute*, 36 Yale L. J. 667 (1927) 11

Posner, Richard A. & Rosenfield, Andrew M., *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83 (1977) 8

Rau, Alan Scott, *Contracting Out of the Arbitration Act*, 8 Am. Rev. Int'l Arb. 225 (1997) 15-17

Rosenberg, Nathan & Birdzell, L. E., Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (1986) 4

Schwartz, Alan, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. Cal. Interdisc. L. J. 389 (1993) 6

Ware, Stephen J., *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 Minn. L. Rev. 703 (1999) 10

Ware, Stephen J., *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. Disp. Resol. 89 (2001) 8

IDENTITY AND INTEREST OF AMICUS CURIAE[1]

Pursuant to Supreme Court Rule 37.3(a), Pacific Legal Foundation (PLF) respectfully submits this brief amicus curiae in support of the petitioners. Written consent was granted by counsel for all parties and lodged with the Clerk of this Court.

PLF was founded 30 years ago and is widely recognized as the largest and most experienced nonprofit legal foundation of its kind. PLF litigates matters affecting the public interest at all levels of state and federal courts and represents the views of thousands of supporters nationwide. Among other things, PLF's Free Enterprise Project defends the freedom of contract, including the right of parties to agree by contract to the process for the resolution of disputes between them. To that end, PLF has participated as amicus curiae in many important cases involving the Federal Arbitration Act and freedom of contract in general, including *Cingular Wireless, LLC v. Mendoza*, 126 S. Ct. 2353 (2006); *Grafton Partners L.P. v. Superior Court*, 36 Cal. 4th 944 (2005), and *Gentry v. Superior Court*, No. S141502 (Cal. Sup. Ct. *petition for review filed* Feb. 28, 2006) (pending). PLF believes its public policy experience will assist this Court in its consideration of the merits of this case.

SUMMARY OF ARGUMENT

The primary goal of the Federal Arbitration Act is to enforce the contractual rights of the parties to a dispute who have agreed to resolve their dispute through arbitration. While arbitration tends to be more efficient than judicial proceedings, contracting parties are free to agree to what appear to be inefficient methods of dispute resolution if that is their

---

[1] No counsel for any party authored this brief in whole or in part. No person or entity, other than amicus curiae, its members or its counsel made any monetary contribution specifically for the preparation or submission of this brief.

preference. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985). If parties choose to add to their arbitration agreements the additional element of federal judicial review, no public policy goals are undermined by abiding by that choice. This Court should interpret section 10 of the FAA as providing *default* rules, not *immutable* rules, because the latter interpretation would not serve the FAA's goal of enforcing the contractual rights of parties who freely choose to adopt an arbitration agreement.

Courts that have ruled against allowing parties to expand judicial review of arbitration awards have relied largely on the theory that such agreements would violate the rule against creating federal jurisdiction by agreement. *See, e.g., Chicago Typographical Union No. 16 v. Chicago Sun-Times, Inc.*, 935 F.2d 1501, 1505 (7th Cir. 1991). But this fundamentally misunderstands the nature of jurisdiction under sections 9 and 10 of the FAA. That Act does not create jurisdiction at all; instead, parties seeking a judicial confirmation of an arbitration award under sections 9 and 10 are required to establish jurisdiction as set forth in the standard federal jurisdiction statutes, 28 U.S.C. §§ 1331 and 1332. Once those elements are satisfied, the district court has general jurisdiction, and the parties who agree to expanded judicial review are therefore doing nothing more than agreeing to certain procedural details for the hearing—as parties in lawsuits are generally allowed to do.

In addition, while some courts of appeals—notably the Seventh Circuit, in *Chicago Typographical Union* and *Ethyl Corp. v. United Steelworkers of America*, 768 F.2d 180, 184-85 (7th Cir. 1985)—have contended that allowing expanded judicial review would undermine the efficiency of arbitration, that conclusion makes two basic errors: first, it places efficient dispute resolution above the freedom of contract as the guiding policy under the FAA. This Court has ruled otherwise. *Byrd*, 470 U.S. at 221; *Volt Info. Sciences, Inc. v. Bd. of Trustees of*

Leland Stanford Junior Univ., 489 U.S. 468, 479 (1989). Second, it rests on a faulty notion of "efficiency": an efficient agreement is not necessarily a *speedy* or *inexpensive* one; rather, it is whatever the parties find suits their needs, and if the parties freely agree to ask a federal judge to review an arbitration decision, that is, by definition, the most efficient arrangement between those parties.

Enforcing an agreement for expanded judicial review therefore is efficient if that agreement was voluntarily entered into by the parties. In addition, it serves the overriding concern of the FAA by ensuring that parties have their contractual agreements enforced. Allowing expanded judicial review of arbitration agreements does not violate rules against expanding federal jurisdiction, and does not otherwise undermine the judicial system. The decision below should therefore be reversed.

ARGUMENT

I

PARTIES SHOULD BE FREE TO ALTER THE DEFAULT RULES GOVERNING CONTRACTS

A. Freedom Means Choice

Freedom of contract is a fundamental principle of American law and society. It is not only a practical instance of constitutionally protected liberty, but it is probably the element of that liberty most frequently relied upon by ordinary Americans. As an aspect of individual liberty, freedom of contract "guarantee[s] to individuals a sphere of influence in which they will be able to operate, without having to justify themselves to the state or to third parties." Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & Econ. 293 (1975). At its core, freedom of contract simply *is* individual autonomy, and interference with that freedom constitutes an obstruction of the individual's freedom to pursue

his or her happiness. Brian A. Blum, *Contracts* § 1.4.1 (2d ed. 2001) ("[t]he power to enter contracts and to formulate the terms of the contractual relationship is . . . an integral part of personal liberty").

In addition, the consistent and predictable enforcement of voluntary agreements fosters social and economic prosperity, because it encourages entrepreneurship, investment, innovation, and exchange. When investors and traders can tailor agreements to meet their specific needs, they will be more willing and able to establish new businesses and to generate further prosperity. *See* Hernando de Soto, *The Mystery of Capital* 157 (2000) ("[l]aw is the instrument that fixes and realizes capital"); Nathan Rosenberg & L. E. Birdzell, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* 116-17 (1986) ("a system of law which seeks to make the legal consequences of human action coherent and predictable . . . . reduce[s] the risks of trading and investing" and is essential to economic growth).

Along with concerns for individual freedom and economic efficiency, contract law must take into consideration certain problems of decentralized knowledge: namely, that third parties cannot know *a priori* what set of rules will best suit the individuals in an economy. Knowledge about particular circumstances is broadly distributed throughout society; it is not held by—and often is not even available to—a central authority. Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519 (1945). Thus a contract law system that allows flexibility at the "local" level—*i.e.*, that allows contracting parties to tailor their agreements to suit their needs—will enable parties to use their knowledge and will avoid interfering with their freedom of choice in ways that increase inefficiency and, ultimately, the cost to the consumers. Businesses that can cater to a customers' specific needs, rather than strictly standardizing the terms of all orders beforehand, will increase consumer

satisfaction, and improve efficiency by ensuring that buyers are not given things they do not want.

Contract law creates default rules to ensure that if parties forget to include certain terms in their contracts, those contracts still will be enforced along with certain "gap fillers" for the unspecified terms which usually are designed to mimic what contracting parties would have wanted, had they considered the subject. *See, e.g.*, U.C.C. § 2-305 (1998) (allowing parties to contract even where no price term has been determined). While the law also creates certain binding limitations on contracts which parties may not negotiate around—civil rights laws, for example, or criminal laws which make certain contracts illegal—the more common sort of rule is a default rule, around which parties may freely devise their own agreements. The law allows parties to waive these rules because

> a meaningful power of exit is one important component of the concept of political freedom .... [A] person who may not "opt out" of a social arrangement is, to this extent, unfree .... [G]enuine consent implies the existence of meaningful alternatives . . . [and] in a free society, persons should have the power and right to contract around the background rules supplied by a legal system.

See Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821, 904 (1992). *See also* Christopher R. Drahozal, *Contracting Around RUAA: Default Rules, Mandatory Rules, and Judicial Review of Arbitral Awards*, 3 Pepp. Disp. Resol. L.J. 419, 421 (2003) (legislatures should "make a particular rule a mandatory rule only if one of the parties to the contract is unable to protect itself from the other, or if the contract has effects on third parties who are unable to protect themselves. Otherwise, the rule should be a default rule.")

Given this "power to exit," contracting parties will tend to choose terms which suit their needs; this improves efficiency by ensuring that parties do not have their hands tied by provisions which they do not want. Contracting around default rules can be costly, but prohibiting parties from doing this can be even costlier. *See* Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. Cal. Interdisc. L. J. 389, 402 (1993) ("[t]he state's choice of a default rule cannot affect the substance of private contracts . . . . [but] will affect total contracting costs").

Because freedom of contract is a basic exercise of liberty, and because a centralized authority simply cannot determine *a priori* the rules that "ought" to be part of every contract, legal restrictions on the freedom to contract around default rules must be justified by some important public reason. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 88 (1989) ("[t]here is surprising consensus among academics at an abstract level . . . [that] [i]mmutable rules . . . [are] justified only if unregulated contracting would be socially deleterious because parties internal or external to the contract cannot adequately protect themselves"). Where there is no social harm to be anticipated, or where that harm can be addressed by less intrusive means, parties should be free to negotiate to accomplish the things they wish to do, including determining the method of adjudicating possible future disputes. In short,

> freedom of contract is the general rule and restraint the exception . . . . In determining the validity of . . . [limits on the right to contract], regard is to be had to the general rule that competent persons shall have the utmost liberty of contracting, and that it is only where enforcement conflicts with dominant public interests [that courts will refuse to enforce them.]

Advance-Rumely Thresher Co. v. Jackson, 287 U.S. 283, 288 (1932).

These principles apply to arbitration agreements as well. As this Court recognized in *Volt*, 489 U.S. at 479, the FAA allows "the enforcement of agreements to arbitrate under different rules than those set forth in the Act itself," because this is consistent with the Act's "primary purpose of ensuring that private agreements to arbitrate are enforced according to their terms." Because arbitration is a matter of contract, the parties to a dispute "are generally free to structure their arbitration agreements as they see fit. Just as they may limit by contract the issues which they will arbitrate . . . so too may they specify by contract the rules under which that arbitration will be conducted." *Id.*

The FAA wisely *fosters*, but does not *dictate* agreements between private parties. It provides default rules which the parties may waive in order to bring their own preferences and knowledge to bear on a problem.

B. Allowing Parties To Tailor Their Agreements Encourages Efficiency and Prosperity

Professor Barnett explains that allowing parties to tailor their agreements to suit their particular needs benefits society as well as the parties themselves because it allows the parties to use their knowledge to accomplish results that could not have been foreseen by lawmakers at some other time and place. Barnett, *supra*, at 894. Morever, alterable default rules for contracts tend to balance out asymmetrical knowledge because if the default rule "is objectionable to the [more] knowledgeable party, [that party] will then explicitly contract around the default rule, and the process of explicitly contracting around that default rule will call the new rule to the attention of the rationally ignorant party, thereby giving that party a chance to

object as well." *Id.* at 895.[2] Thus a default rule can "reveal personal and local knowledge" and thereby increase the likelihood that agreements will actually represent a meeting of the minds. *Id.*

In addition to helping harness knowledge, allowing parties to negotiate around default rules increases efficiency by ensuring that parties are not given costly overprotection, or deprived of protections that they desire. Requiring parties to abide by certain terms in a contract when they do not want to will in many cases cost more than their agreement to waive those default protections, and whenever this happens, parties will contract around those rules. "A law of contract not based on [such] efficiency considerations will therefore be largely futile." Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83, 89 (1977).

Allowing parties to determine the terms of their own arbitration agreements therefore ultimately decreases costs to the consumer. Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. Disp. Resol. 89 (2001) ("[r]elative to litigation, arbitration provides opportunities for a business to save on its dispute-resolution costs . . . [and] competition forces businesses to pass their cost-savings on to consumers"). A legal system which tries to predict what the contracting parties will want as part of their contracts must therefore "assume that individuals remain free to contract around that rule, and a legal system that denies private parties the right to vary rules in this way will tend to be less efficient than a system that adopts the same rules but

---

[2] The fact that the parties to a dispute are more likely to know the relevant information better than any third party, and to be able to apply it efficiently is one reason why courts often adopt trade usage itself into the law. *See, e.g.*, U.C.C. § 1-205 (2007) (adopting "trade usage" as part of the Uniform Commercial Code).

permits contractual variation." Anthony T. Kronman, *Specific Performance*, 45 U. Chi. L. Rev. 351, 370 (1978). *See also* David D. Haddock, et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 736 (1987) ("[t]he ability of firms to contract around costly legal rules when lower-cost private alternatives are available must be a feature of any efficient standard-form contract").

In the practical world of a dynamic economy, allowing parties to tailor their agreements to meet their specific needs is exceedingly important because each transaction is unique. Permitting parties the maximum freedom to arrange the terms of their transactions allows those who know most about the issues at hand to exert their knowledge and expertise.

This rationale lay behind the rise of a Medieval-era dispute resolution system known as the Law Merchant, of which modern arbitration is a descendant. *See generally* Bruce L. Benson, *The Enterprise of Law* 30-41 (1990). A private arbitration system for resolving cross-border disputes between commercial traders on the Mediterranean, the Law Merchant was popular in large part because it "developed to resolve commercial disputes involving highly technical issues. Merchant court judges were chosen from the relevant merchant community." *Id.* at 34. *See also* Sarah Rudolph Cole, *Managerial Litigants? The Overlooked Problem of Party Autonomy in Dispute Resolution*, 51 Hastings L.J. 1199, 1235 (2000) ("[a]rbitration as we know it was developed by the merchant class in medieval western Europe"). Parties to contracts could choose to have their disputes settled by private, for-profit arbitrators with expertise in the relevant trade. Even today, many private arbitration systems are available for people transacting business over the Internet, and they are favored by trading partners because they are faster and cheaper, and because the judges in these systems are trained in the subject matter of the dispute. *See generally* Lan Q. Hang, *Online Dispute Resolution Systems: The Future of Cyberspace Law*,

41 Santa Clara L. Rev. 837 (2001). Because they are privately managed, these dispute resolution systems tend to be less time-consuming and more responsive to the needs of the consumers themselves; the judges tend to be more expert in the relevant trade; and the parties themselves can decide upon the terms for dispute resolution. "A market for law . . . produces better law than does a system in which government monopolizes lawmaking. The principles animating privatization around the world apply to lawmaking just as they apply to coal mining . . . ." Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 Minn. L. Rev. 703, 747 (1999).

II

THE FEDERAL ARBITRATION ACT WAS DESIGNED TO MAXIMIZE FREEDOM OF CHOICE

While arbitration and freedom of contract do tend toward greater efficiency, the primary goal of arbitration is not efficiency, but the maximization of freedom of choice. In *Byrd*, 470 U.S. 213, the Court, speaking through Justice Marshall, "reject[ed] the suggestion that the overriding goal of the Arbitration Act was to promote the expeditious resolution of claims." *Id.* at 219. Instead, the FAA was designed "first and foremost . . . to enforce agreements into which parties had entered, and we must not overlook this principal objective when construing the statute, or allow the fortuitous impact of the Act on efficient dispute resolution to overshadow the underlying motivation." *Id.* at 220. Parties may choose methods of dispute resolution that appear to be inefficient, and the Act calls for enforcement of those agreements.

As far as efficiency is concerned, any agreement to which the parties voluntarily enter is *by definition* efficient, because the only way to measure economic value, and thus to measure the optimality of an agreement, is to observe the fact that the

parties to a contract have, in fact, agreed to it. *See generally* James M. Buchanan, *Rights, Efficiency, and Exchange: The Irrelevance of Transactions Cost* (1984), *reprinted in* James M. Buchanan, 1 *The Logical Foundations of Constitutional Liberty* 260, 273-74 (1999) ("voluntary exchanges among persons, within a competitive constraints structure, generate efficient resource usage, *which is determined only as the exchanges are made*") (emphasis added). *See also* Israel M. Kirzner, *Market Theory and the Price System* 35 (1963) ("[e]fficiency for a social system means the efficiency with which it permits its individual members to achieve their several goals").[3]

But the primary purpose of the FAA is not to achieve efficiency, but to enforce the parties' agreement. The purpose of the FAA is to empower parties to settle disputes in the ways they choose, rather than to force them to submit to determination by the judiciary. Wharton Poor, *Arbitration Under the Federal Statute*, 36 Yale L. J. 667, 677 (1927) ("[t]he principle of arbitration is, in substance, no more than allowing the parties to select and pay their own arbiter rather than to have one thrust upon them by the government").

---

[3] Any other measure of the efficiency of an agreement will necessarily substitute some other person's subjective speculations for the parties' own evaluations of the utility of their agreement, thus failing to account for the actual value of the agreement. *See* Buchanan, *supra*. For example, to hold that "wealth maximization" is the definition of utility will fail to account for those to whom wealth maximization is *not* a goal. *Cf.* Reza Dibadj, *Weasel Numbers*, 27 Cardozo L. Rev. 1325, 1359 (2006). To require an ascetic monk to take a course of action that maximizes his worldly goods will actually *impede* his utility maximization. Due to the fact that no outside observer can have the full knowledge of the utility functions of the parties to a contract, the *only* valid criterion for determining whether an agreement maximizes their utility is the fact that the parties themselves have agreed to the exchange.

Although at the time of the FAA's passage, many lawyers and judges recognized the greater efficiency and freedom of choice available through arbitration, *see, e.g.*, Alfred N. Heuston, *The Settlement of Disputes by Arbitration*, 1 Wash. L. Rev. 243, 243-44 (1926), the common law handicapped arbitration by prohibiting specific enforcement of arbitration agreements. *See Southland Corp. v. Keating*, 465 U.S. 1, 18 (1984) (opinion of Stevens, J., concurring in part & dissenting in part). This meant that even if the parties had agreed before the dispute arose that they would settle any disagreements through arbitration, a party could later file a lawsuit in court; the court would refuse to stay the proceedings pending arbitration or to force the parties to submit to the arbitration as agreed.

The American Bar Association responded to this problem by drafting federal legislation which would incorporate arbitration into the federal judicial system, allowing disputes to be resolved by arbitration first, and then confirmed by the federal courts. The Congress that debated and then enacted the FAA argued about many issues, but generally agreed that arbitration agreements "are purely matters of contract, and [that] the effect of the [FAA] is simply to make the contracting party live up to his agreement .... An arbitration agreement is placed upon the same footing as other contracts, where it belongs." H.R. Rep. No. 96, 68th Cong., 1st Sess. at 1 (1924). *See also* Christopher R. Drahozal, *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, 78 Notre Dame L. Rev. 101, 149 (2002) (quoting Rep. Graham: "[t]his bill simply provides for one thing, and that is to give an opportunity to enforce an agreement . . . to arbitrate, when voluntarily placed in the document by the parties .... It does not involve any new principle of law except to provide a simple method by which the parties may be brought before the court in order to give enforcement to that which they have already agreed to"). Nothing in the text or history of the FAA

suggests that Congress intended to prevent parties from choosing to expand the degree of judicial review to which their arbitration would be subjected. *See* Milana Koptsiovsky, Note: *A Right to Contract for Judicial Review of an Arbitration Award: Does Freedom of Contract Apply to Arbitration Agreements?*, 36 Conn. L. Rev. 609, 615 (2004) ("[n]owhere did the legislative history state that a court is precluded from enforcing a contract on its own terms if the contract expands the FAA").

Under the terms of the FAA, contracting parties who anticipate arbitration have a great deal of flexibility in choosing the terms of dispute resolution. First, they may choose to opt out of judicial confirmation under the FAA entirely. *See* section 9 ("[i]f the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration . . . [then] the court must grant such an order . . . .").

In addition, they may choose the forum in which the arbitration is heard, the arbitrator and the rules of procedure, and which state's *substantive* law shall govern a dispute. *Cf. Volt*, 489 U.S. at 476 ("[t]here is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate"). This last is particularly important because if parties may choose the body of law that governs disputes—whether it be the law of a forum state or even private religious traditions, *see, e.g., Elmora Hebrew Ctr. v. Fishman, Inc.*, 570 A.2d 1297 (N.J. Super. Ct. 1990) (enforcing decision of religious arbitrators)—then there would appear to be little reason not to allow the parties to also choose federal law to govern their disputes. And because parties also may agree as to *who* shall resolve a dispute, there is little reason for concern if they choose a federal district court judge to review their dispute at some stage of the process, so long as they have properly established federal jurisdiction.

In short, if each of the substantive elements of *de novo* review may be adopted by contract between the parties without violating any law or any person's rights, then there is no reason that contracting parties should be prevented from bundling those elements together by calling for *de novo* review by a federal judge in their arbitration agreement. Doing so is just another way of stating that the parties have chosen as part of their enforceable agreement to undergo a round of arbitration before potentially asking a federal judge to review that arbitration award. If such a term is incorporated into the agreement, a federal court that applies *de novo* review later is simply enforcing the terms of the contract as contemplated by section 9 of the FAA.

The FAA's focus on maximizing freedom of choice and enforcing the agreements that parties freely make indicates a more general concern with autonomy among contracting parties which, as Professor Cole has argued, ought to be respected by courts so long as the choices contracting parties make are consistent with a stable application of the rule of law. If a statute authorizes the court to grant the parties' request for expanded judicial review, argues Cole, and if doing so would not undermine the court's institutional integrity, then courts should allow the parties to expand their agreements and incorporate judicial review. Cole, *supra*, at 1232. Because the language of the FAA is amenable to both the argument that no expanded review is permissible, and that parties may expand judicial review, the broader legislative goal of freedom of contract should prevail, and parties should be allowed to exercise their knowledge to accomplish their goals—*i.e.*, to contract for greater review. This Court should therefore read section 10's factors as *default* rules, not immutable rules.

Section 10 sets out background standards which will govern if the parties express no desire to the contrary, and parties should not be barred from contracting around these defaults except where some social harm is to be anticipated

from their doing so. This interpretation is not contrary to the language of the FAA, and is consistent with the purpose underlying that legislation. It therefore ought to prevail. *See Smith v. Townsend*, 148 U.S. 490, 494 (1893):

> [F]or the sure and true interpretation of all statutes . . . four things are to be discerned and considered: First. What was the common law before the making of the act. Second. What was the mischief and defect for which the common law did not provide. Third. What remedy the [legislature has] resolved . . . . Fourth. The true reason of the remedy.

Quoting *Heydon's Case*, (1584) 76 Eng. Rep. 637, 638 (K.B.); *accord, Pierson v. Ray*, 386 U.S. 547, 561 (1967) (applying *Heydon's Case*). Aside from cases where the arbitration agreement for some reason fails to represent a meeting of the minds—cases already covered by section 10—there does not appear to be any social harm to be anticipated from allowing parties to request further review of arbitration decisions by a federal judge. On the contrary, if the parties agree to such review, social harm results from *failing* to enforce that agreement: it undercuts the primary purpose of the Act, increases inefficiency, and intrudes on the freedom of choice of contracting parties.

Allowing parties to decide the terms for the resolution of their disputes maximizes individual satisfaction, increases social efficiency, improves the accuracy of resolution, respects the autonomy of the parties, and fits well with long-standing common law rules recognizing that the parties themselves probably know best how their disputes should be resolved. Section 10's specified grounds for denying the confirmation of an arbitration award therefore should be interpreted as default rules to which parties may knowingly add others if they so choose. Alan Scott Rau, *Contracting Out of the Arbitration*

Act, 8 Am. Rev. Int'l Arb. 225, 231 (1997) (section 10's provisions are "not . . . imperative command[s] of public policy," but "a ready-made stock of implied terms" which "may naturally be varied by an express agreement of the parties").

As Professor Rau has put it, the FAA was intended to ensure that parties who agree to arbitration "need not fear an officious or meddlesome inquiry into the merits which would impair the efficacy of the arbitral process for them." Rau, *supra*, at 231. But this purpose has nothing to do

> with the situation where the parties are eager to depart from the protective rule of § 10. It is one thing to say that their awards must have legal currency in accordance with the parties' presumed wishes—it is something totally different to say that their awards will have this currency, by God, over the parties' expressed wishes to the contrary.

Id. For a court to declare that it will not review an arbitration award even though the parties themselves agree to this would simply be a "paternalistic" "interference with private autonomy." *Id.* Indeed, as Justice Harlan Stone put it in 1923, shortly before the enactment of the FAA, "that two merchants of full age and mental competency should not be permitted by the laws of their country to stipulate for the adjustment and settlement of controversies between them . . . would seem incredible to a layman." Quoted in *Advantages Ascribed to Arbitration*, 9 J. Am. Jud. Soc. 73, 78 (1925).

III

PARTIES WHO EXPAND JUDICIAL REVIEW OF THEIR ARBITRATION AGREEMENTS UNDER THE FAA ARE NOT "CREATING JURISDICTION BY CONTRACT"

The primary concern of the court below, as well as the other circuits which have taken the same position, is that

allowing *de novo* review of those agreements by federal courts would be tantamount to creating federal jurisdiction by agreement, which parties obviously may not do. *See, e.g., Chicago Typographical Union*, 935 F.2d at 1505.

But the FAA does not confer jurisdiction. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 26 n.32 (1983). Any federal district court hearing a matter under the FAA's confirmation provisions must have jurisdiction established on a basis provided for by 28 U.S.C. §§ 1331 or 1332. And assuming that the jurisdictional requirements of *those* statutes are satisfied, the parties to an arbitration dispute who come before a district court are not manipulating or expanding the court's *jurisdiction* when they agree to the terms on which the court may deny a confirmation order. They are merely choosing the *procedures*, or the standard of review, for a confirmation proceeding. Parties are not only entitled to do this under the FAA, but are usually allowed to govern the procedural details of their cases under the general principles of case management which allow them to stipulate to such matters as waiving a jury. *See, e.g.*, Fed. R. Civ. P. 39(a) (allowing wavier of jury by stipulation).

The situation would be different if the parties to the arbitration were to agree that their arbitration agreement could be reviewed by a court of appeals, or by this Court, which would not have original jurisdiction under federal statute, or if parties whose dispute is not within the original jurisdiction of the district court asked a court to review it anyway. But where a district court *does* have personal and subject matter jurisdiction over a case, then the contracting parties are doing nothing that is not already done by the FAA when they agree to have a federal judge review their arbitration matter for errors other than those explicitly listed in section 10. Rau, *supra*, at 227-28.

As Judge Kozinski put it in his opinion in *Kyocera*, parties may not "impose on the federal courts burdens and functions that Congress has withheld," but so long as a case has "an independent jurisdictional basis" authorizing review under the FAA, then judicial review is substantively no different than the enforcement of the arbitration agreement itself, and the court is acting just as it would "in appeals from administrative agencies and bankruptcy courts, or on habeas corpus." *LaFine Tech. Corp. v. Kyocera Corp.*, 130 F.3d 884, 891 (9th Cir. 1997) (Kozinski, J., concurring).

In *Chicago Typographical Union*, Judge Posner cited four cases to support his view that contracting for expanded judicial review of arbitration awards counted as "creating jurisdiction by agreement": *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 37-38 (1987); *Indep. Employees' Union v. Hillshire Farm Co., Inc.*, 826 F.2d 530, 532-33 (7th Cir. 1987); *Hill v. Norfolk & Western Ry. Co.*, 814 F.2d 1192, 1194-95 (7th Cir. 1987); and *Ethyl Corp.*, 768 F.2d at 184-85. But none of these cases is applicable to an agreement such as this one.

In *Misco*, this Court found that federal courts may not review arbitration agreements regarding collective bargaining contracts, because such review would undermine the policies underlying "federal statutes regulating labor-management relations." *Misco*, 484 U.S. at 37. Federal labor laws were designed to organize "'settlement of grievance disputes arising over the application or interpretation of the existing collective-bargaining agreement,'" *id.* (quoting 29 U.S.C. § 173(d)). But the policies involved in the FAA have nothing to do with the efficient and fair settlement of labor disputes. Unlike the situation with labor contracts, a case such as this one involves no governmental attempt to remedy an alleged imbalance of bargaining power to suit political needs; rather, a case like this involves mature parties able to bargain for themselves at arm's length, and to reach a mutual agreement. The primary goal of federal labor laws is to reach a rapid and politically acceptable

settlement between labor and management. The primary goal of the FAA, by contrast, is to enforce the parties' agreements.

Moreover, the agreement here included a provision for judicial review, which was not the case in *Misco*. There, the Court was concerned that " 'the moving party should not be deprived of the arbitrator's judgement, when it was his judgment and all that it connotes that was bargained for.' " *Id.* at 37 (quoting *United Steelworkers of America v. American Mfg. Co.*, 363 U.S. 564, 568 (1960)). Here, both parties bargained for review by a federal judge, and they are not being "deprived" of anything.

Likewise, the arbitration agreement in *Hillshire Farm* did not contain a provision allowing for judicial review of the arbitration award. That case, too, involved arbitration under a collective bargaining agreement; the union brought suit in state court to vacate part of the arbitration award on various state grounds, and the employer removed the case to federal court pursuant to the Labor Management Relations Act, 29 U.S.C. § 185 (1982). *See Hillshire Farm*, 826 F.2d at 532. The district court ruled for the union, and although the court of appeals reversed, it found that the case was properly brought because under the Labor Management Relations Act, a party was entitled to seek judicial review in certain "extremely narrow" circumstances. *Id.* This policy reflects the fact that "parties to a collective bargaining agreement have bargained for arbitration as a dispute resolution process and fosters that process." *Id.* Thus, unlike the situation here, the parties in *Hillshire Farm* had not agreed to judicial review of the final arbitrator's decision, and the limited judicial review applicable in that case was based on public policies regarding collective bargaining and labor management, which are not applicable here. The arbitration agreement in *Hill* also involved a collective bargaining contract, and there was no indication of an agreement between the parties for expanded judicial review. *See* 814 F.2d at 1194.

In *Ethyl Corp.*, Judge Posner provided a more thorough explanation of why he believed judicial review of arbitration awards is not available—although in that case, too, there was no indication that the parties agreed to such review, as they did in this case. *See* 768 F.2d at 183. There, he explained that allowing judicial review "tends to judicialize" the arbitration process. *Id.* at 184. This is inappropriate, he argued: the point of arbitration is "to provide an alternative to judicial dispute resolution, not an echo of it," and allowing judicial review of arbitration would create pressure for arbitrators to act more like courts. *Id.* Moreover, allowing judicial review would "make arbitration a three-tiered, rather than as in normal adjudication a two-tiered, process," because first arbitrators, then district courts, then circuit courts, would review a decision. This "would make arbitration more judicial than adjudication." *Id.* In *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*, 341 F.3d 987, 998 (9th Cir. 2003) (*en banc*) the Ninth Circuit echoed these arguments, concluding that "[b]road judicial review of arbitration decisions could well jeopardize the very benefits of arbitration, rendering informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process."

While these may all be good arguments against including a provision for judicial review in an arbitration procedure, they are not good reasons for defeating the parties' own agreement to create such a three-tiered process. The point of arbitration, as the Court in *Byrd*, emphasized, is *not* primarily to ensure that disputes are resolved quickly, or to force parties to adopt any particular method of dispute resolution, but "to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements . . . even if the result is 'piecemeal' litigation, at least absent a countervailing policy manifested in another federal statute." *Byrd*, 470 U.S. at 221.

The Seventh Circuit's concerns about "judicializing" arbitration is an appropriate concern where judicial review is engaged contrary to the wishes of a party, but if the parties wish to create such review, their will must prevail. The *Byrd* Court was "not persuaded" that any "conflict between two goals of the Arbitration Act—enforcement of private agreements and encouragement of efficient and speedy dispute resolution—must be resolved in favor of the latter." *Id.* Instead, enforcing "the contractual rights of the parties" is the principal goal of the FAA *Id.*

Fortuitously, this does not mean that courts must sacrifice efficiency, because if an arbitration agreement truly represents the will of the parties, then it *is* the efficient method of resolving the dispute. The parties would not have freely agreed to an arbitration method if that method did not answer their concerns in the way they thought most economical, and to bar them from their agreement is therefore to deprive them of that additional utility which their preferred agreement provides them. *See* Buchanan, *supra*; Donald J. Boudreaux, et al., *Talk is Cheap: The Existence Value Fallacy*, 29 Envtl. L. 765, 785 (1999) ("[i]n market transactions, we can assume that all individual trades increase individual utility, because the occurrence of the trade itself suggests that the individual values the good received more highly than the good surrendered").

CONCLUSION

The decision of the Court of Appeals should be *reversed*.

DATED: July, 2007.

Respectfully submitted,

DEBORAH J. LA FETRA
TIMOTHY SANDEFUR
Counsel of Record
Pacific Legal Foundation
3900 Lennane Drive, Suite 200
Sacramento, California 95834
Telephone: (916) 419-7111
Facsimile: (916) 419-7747

Counsel for Amicus Curiae Pacific Legal Foundation